Nos. 354

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELLIOTT H. WHEELER AND ROLLO C. WHEELER, EXECUTORS OF THE ESTATE OF JOHN H. WHEELER, DECEASED

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CORNELIA W. GOOD

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v.

ELLIOTT H. WHEELER

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v.

FRANCES V. WHEELER

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that writs

of certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in the above causes on May 16, 1944, reversing decisions of the Tax Court of the United States.

OPINIONS BELOW

The findings and opinion of the Tax Court (R. 57–81) are reported at 1 T. C. 640. The opinion of the Circuit Court of Appeals (R. 121–130) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 16, 1944 (R. 130). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The taxpayers were stockholders in a corporation which was liquidated in December 1938; the assets were distributed among the stockholders who elected in writing to be taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938. The corporation had issued all its capital stock for assorted properties in a nontaxable exchange in 1925 and immediately succeeding years and it subsequently sold the properties so acquired.

1. Whether, in computing the accumulated "earnings and profits" (sec. 112 (b) (7) (E) of the Revenue Act of 1938) of the corporation at

the time of its liquidation, the proper basis for determining the earnings and profits which resulted to the corporation from the sale of the properties for which it had issued its stock is the value of the property at the time the corporation acquired it, or is the cost of the property to the transferors, which became the basis for determining the taxable gain or allowable loss of the corporation on the sale or other disposition of the property.

2. Whether Section 501 of the Second Revenue Act of 1940, amending Section 115 of the Revenue Act of 1938 (and the corresponding provision of each preceding Act) as of the date of its enactment, in order to define with certainty the meaning of the statutory term "earnings and profits" of a corporation as used in Section 115, is clarifying legislation or retroactive legislation.

3. Whether, if Section 501 is retroactive legislation, it deprives respondents of property without due process of law.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statutes and regulations involved are set forth in Appendix A, *infra*, pp. 21–32. The pertinent Congressional Committee Reports are set forth in Appendix B, *infra*, pp. 33–37.

STATEMENT

John H. Wheeler, now deceased and represented by his executors, and the four other re-

spondents owned 90 percent and Rollo C. Wheeler the remaining shares of the stock of the John H. Wheeler Company, a California corporation, at the time of its liquidation in December 1938.[1] John H. Wheeler and his wife, Francis V. Wheeler, had organized the John H. Wheeler Company in 1925, and, during the years following its organization and until the year 1929, the two organizers received the company's 4,918 shares of stock in consideration of certain securities which they transferred to the corporation. The properties so transferred were worth $491,800 and had cost the two organizers $304,688.49. (R. 31–32, 59–60.)

Prior to liquidation, the corporation sold most of the property it had acquired in exchange for its stock upon its organization, and, in accordance with the applicable Revenue Acts (*viz.*, Section 204 (a) (8) of the Revenue Act of 1924 and corresponding provisions of later Acts), it used the basis of its transferors (John H. Wheeler and wife) in computing its taxable gain or allowable loss upon such sales (R. 33, 60). It invested the net proceeds of its operations in assorted securities (see R. 34).

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[1] John H. Wheeler lived until June 14, 1939 (R. 36), but, as his executors represent him, they are sometimes referred to herein as "taxpayers." There were five appeals to the Tax Court, one by each of four individuals and one by the estate. The issue being the same in each case, a consolidated record was prepared and used below. (See R. 113–117.)

On December 2, 1938, after giving consideration to the application of Section 112 (b) (7) (E) of the Revenue Act of 1938, the stockholders of the John H. Wheeler Company dissolved the corporation, and all the assets were proportionately distributed in liquidation to the stockholders during December 1938. The assets so distributed consisted of securities having a fair market value of $624,560[2] and cash in the sum of $111.84. (R. 34, 61–62.) The stockholders of the Wheeler Company, the fair market value of the securities and the cash which each received in the liquidation, and the basis of their Wheeler Company stock were as follows (R. 60, 63):

	Shares held	Fair market value of cash and securities received in liquidation	Basis of Wheeler Company stock
John H. Wheeler	2,459	[1] $312,335.92	[2] $153,505.01
Frances V. Wheeler	491⅘	62,467.18	30,701.00
Elliott H. Wheeler	491⅘	62,467.18	30,701.00
Cornelia W. Good	491⅘	62,467.18	30,701.00
Ysabel F. Berliner	491⅘	62,467.18	30,701.00
Rollo C. Wheeler	491⅘	62,467.18	30,701.00
Total	4,918	624,671.82	307,010.01

[1] See also R. 24.
[2] Cf. R. 25.

While the foregoing table discloses that each of the stockholders realized through the liquidation

[2] Of the properties so distributed, only securities worth $693.87 had been acquired by the John H. Wheeler Company after April 9, 1938. John H. Wheeler's one-half of those securities was worth $346.94. (R. 24, 35, 64, 78; Cf. R. 50.)

of the Wheeler Company a gain in excess of 100 percent on his investment (see Section 115 (c), Revenue Act of 1938, Appendix A, *infra*, pp. 26–27), respondents desired to have their respective gain recognized and taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938 (Appendix A, *infra*, p. 24). Accordingly, each of the stockholders now before this Court executed (and filed with the Treasury Department) a written election on Treasury Form 964 to have his gain in the liquidation so taxed (R. 35, 63–64). As each of the stockholders had received, among other assets in the liquidation, his pro rata share of securities which the Wheeler Company had acquired after April 9, 1938, and of the distributed cash, each of the present taxpayers reported for income tax purposes his proportionate part of the sum ($805.71) of those two items (see Statement, *supra*, p. 5, and fn. 2, *ibid.*). Thus, John H. Wheeler, who owned one-half of the liquidating corporation's stock, reported $402.86 as taxable under Section 112 (b) (7) (E), while each of the other shareholders reported $80.57 as the amount of his taxable gain (R. 35, 64). Each stockholder treated the Wheeler Company as a deficit corporation and none of them reported any amount in his respective income tax return as a dividend receipt in connection with the liquidation of the John H.

Wheeler Company (*i. e.*, as a distribution out of corporate "earnings and profits" (sec. 112 (b) (7) (E)) accumulated after February 28, 1913) (R. 35–36).

The Commissioner of Internal Revenue concluded that the Wheeler Company was not a deficit corporation and determined that the accumulated "earnings and profits" of the Wheeler Company as of December 2, 1938, amounted to $132,813.38 (R. 64). Accordingly, although each shareholder had realized a substantially greater gain in the liquidation, the Commissioner determined that, under Section 112 (b) (7) (E), each was taxable on only the amount which he had reported for tax purposes plus his share of the distributed "earnings and profits" of the corporation, and that the latter were received as follows (R. 64):

John H. Wheeler	$86,406.69
Elliott H. Wheeler	13,281.38
Frances V. Wheeler	13,281.38
Cornelia W. Good	13,281.38
Ysabel Berliner	13,281.38

The Commissioner determined the earnings and profits of the Wheeler Company at the time of its liquidation by using the cost to John H. Wheeler and his wife of the securities they had previously transferred to the Wheeler Company in exchange for its stock as the cost or basis of those securities to the Wheeler Company. Since such cost was—

$180,314.99[3] less than the book figure at which the company had entered those securities in its books and since the corporation's book deficit, computed by the use of its book figures, was $47,501.61, the undistributed gains, earnings and profits of Wheeler Company at the time of its liquidation were $132,813.38.[4] (R. 27, 33, 65.)

The Tax Court adjusted the Commissioner's computation of corporate "earnings and profits" at liquidation by an item of $5,953.06 (R. 81)—which was not made an issue in the Circuit Court of Appeals, the Commissioner not having taken a cross-appeal—and otherwise sustained the Commissioner's determination. The Circuit Court of Appeals reversed the decision of the Tax Court.

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[3] The fair market value of all properties which the Wheeler Company acquired for its stock ($491,800), minus the cost of those properties to the corporation's predecessors in title ($304,684.49), minus $6,800.52 (the excess of book value over transferors' cost of original securities unsold at liquidation of Wheeler Company), constitutes the $180,314.99 (R. 27; cf. R. 33).

[4] The sum of $180,314.99 minus $47,501.61 equals $132,813.38. A more detailed computation of the Wheeler Company's earnings and profits at liquidation appears at R. 17–18. There is, however, an error of $1,000 in that computation, since it is undisputed between the parties that, without regard to the $5,953.06 item mentioned in the last paragraph of this Statement, the Wheeler Company had "earnings and profits" of $132,813.38 on December 2, 1938, if in determining those "earnings and profits" it must use, as the Government contends, the basis of its two predecessors in title for the properties for which the company had issued all its stock.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that in computing the accumulated "earnings and profits" (sec. 112 (b) (7) (E) of the Revenue Act of 1938) of the John H. Wheeler Company, a corporation, at the time of its liquidation, the basis for properties acquired in nontaxable exchanges in consideration of its own stock, and subsequently sold, was the fair market value of the properties at the date the corporation acquired them, rather than the cost of the property to the transferors, which became the corporation's basis for determining its taxable gain or allowable loss on the sale or other disposition of the properties.

2. In holding that Section 501 of the Second Revenue Act of 1940, amending Section 115 of the Revenue Act of 1938 (and the corresponding sections of prior Revenue Acts) as of the date of its enactment, is retroactive and not clarifying legislation.

3. In holding that Section 501 is unconstitutional as applied to this case because of objectionable retroactivity.

4. In reversing the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. The Circuit Court of Appeals has erroneously decided a question of far-reaching importance in the administration of the revenue

laws. It has conceded that Section 501 of the Second Revenue Act of 1940 (Appendix A, *infra*, pp. 27–29) is in terms applicable but has held the enactment invalid as applied to this case. The basis for its decision is that the provision, which was designated and designed by Congress as clarifying legislation to resolve any possible obscurity in the meaning of the statutory term corporate "earnings or profits," used in Section 115 of the Internal Revenue Code (Appendix A, *infra*, pp. 25–27), and in all preceding Revenue Acts,* was not clarifying legislation, but was new legislation which changed existing law and undertook to change retroactively the meaning of the statutory phrase corporate "earnings or profits" as used in Section 115 of the Revenue Act of 1938 (and the corresponding provision of preceding Acts) and that it served to deprive the several taxpayers of property without due process of law.

Since the adoption of the Sixteenth Amendment, all the Revenue Acts have included "dividends" in the gross income of individuals which,

* See Section 201 (a) of the Revenue Acts of 1918, c. 18, 40 Stat. 1057; 1921, c. 136, 42 Stat. 227; 1924, c. 234, 43 Stat. 253; Section 115 (a) of the Revenue Acts of 1928, c. 852, 45 Stat. 791; 1932, c. 209, 47 Stat. 169; 1934, c. 277, 48 Stat. 680; 1936, c. 690, 49 Stat. 1648, and 1938.

Section 115 (c), which is involved here, refers to Section 112. The Commissioner determined respondents' tax under subparagraph (b) (7) (E) of Section 112, in accordance with respondents' election to be taxed thereunder (see Statement, *supra*, pp. 5–6). The Committee reports (Appendix B, *infra*, pp. 33–37) reveal that Congress intended Section 501 to apply to Section 112, as the courts below recognized.

less deductions, is subject to tax. All Revenue Acts from that of 1918 (Section 201 (a) thereof) to and including Section 115 (a) of the Internal Revenue Code, have defined the term "dividends" as any distribution made by a corporation, whether in cash or other property, out of its "earnings or profits" accumulated since February 28, 1913. In time Congress provided that no gain or loss should be recognized upon the transfer of property to a corporation by persons in exchange for the corporation's stock, where immediately after the exchange the transferors were in control of the corporation,[6] and then to prevent evasions[7] provided that the basis to the corporation for property so acquired after December 31, 1920, should be the same as it would be in the hands of the transferor, adjusted by the amount of any gain or loss recognized to the transferor under the law applicable to the year of the transfer.[8]

Eventually some taxpayers raised the question whether a corporation's basis, for determining its "earnings or profits" upon the sale or other dis-

[6] See, *e. g.*, Section 202 (c) (3), Revenue Act of 1921; Section 203 (b) (4), Revenue Act of 1924; Section 112 (a) (5), Internal Revenue Code.

[7] See, *e. g.*, Section 204 (a) (8), Revenue Acts of 1924 and 1926, c. 27, 44 Stat. 9; Section 113 (a) (8), Internal Revenue Code.

[8] Thus, the basis to the John H. Wheeler Company for the properties acquired from Wheeler and his wife in exchange for the company's stock was $304,684.49, although the properties were worth $491,800. (See R. 27.)

position of property for which it had issued its stock, was the same as the corporation's basis for determining its gain or loss from the particular sale or disposition of the property. To resolve any possible obscurity on this point the Treasury Department covered it by regulation. Article 115–1, Treasury Regulations 86, relating to the Revenue Act of 1934, provided:

> Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized [for tax purposes] under that section.

The same provision was repeated under subsequent Regulations which implemented like provisions of the subsequent Revenue Acts.[9] That regulation had not been held invalid by any tribunal either at the time the John H. Wheeler Company was liquidated[10] or at the time of the

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[9] See Article 115–3, Treasury Regulations 94 (1936 Act), and Treasury Regulations 101 (1938 Act); Section 19.115–3 of Treasury Regulations 103, and Section 29.115–3 of Regulations 111, promulgated under the Internal Revenue Code.

[10] In *F. J. Young Corp.* v. *Commissioner*, 35 B. T. A. 860 (decided in 1937), a case in which the regulation was not involved, it was held that a "gain" which resulted from a tax-free exchange of securities should be considered as "earnings or profits" out of which a dividend, within the meaning of Section 115 of the Revenue Act of 1928, could be paid. This decision was affirmed in 1939 (between the date of the liquidation of the Wheeler corporation and the passage of the Second Revenue Act of 1940). *Commissioner* v. *F. J. Young Corp*, 108 F. 2d 137 (C. C. A. 3rd). See also *W. S. Farish & Co.* v. *Commissioner*, 38 B. T. A. 150, decided by

enactment of the Second Revenue Act of 1940.[11] The stockholders of the John H. Wheeler Com-

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the Board in 1938, affirmed in 1939 (*Commissioner* v. *W. S. Farish & Co.*, 104 F. 2d 833 (C. C. A. 5th)), in which the regulation was not mentioned.

Some of the earlier Board of Tax Appeals decisions cited by the Circuit Court of Appeals (fn. 3 to opinion), however, are largely irrelevant to the present case. *E. g.*, *Ayer* v. *Commissioner*, 12 B. T. A. 284, was decided in favor of the Government in 1928. There the Board held that a 1922 distribution out of a corporation depletion reserve, based upon a discovery value which exceeded cost or March 1, 1913, value, was a distribution out of corporate "earnings or profits" accumulated since March 1, 1913, and was therefore taxable as a dividend to stockholders. See also *Weyerhaeuser* v. *Commissioner*, 33 B. T. A. 594. At most, a few of these cases suggest the inference that in a proper case the Board of Tax Appeals might disagree with the Commissioner's view set forth in the 1934, 1936, 1938, and subsequent Treasury Regulations.

[11] Except for the instant case, this Treasury Regulation has not been held invalid by any appellate court since the liquidation of the Wheeler corporation.

In *Estate of Fred J. Fisher* v. *Commissioner*, decided February 9, 1944 (1943–1944 Tax Court Memorandum Decisions Service, par. 44,034), the Tax Court held that the basis, in cases pending before the Board of Tax Appeals or any court of the United States on September 20, 1940, for determining corporate earnings and profits from the sale of property which the corporation had acquired in a tax-free transaction was the market value of the property at the date the corporation acquired it. The Commissioner, however, on June 22, 1944, filed a petition for a review of that decision of the Tax Court by the United States Circuit Court of Appeals for the Sixth Circuit. The case involves that portion of Section 501 (c), not involved here, which provides that cases pending on September 20, 1940, shall not be affected. See pp. 28–29, *infra*, and the Senate Committee Report, p. 37, *infra*.

pany liquidated their corporation in December 1938, charged with knowledge of the applicable Treasury Regulations, which they chose to disregard in making their returns.

By Section 501 of the Second Revenue Act of 1940, Congress specifically endorsed and confirmed the Commissioner's position set forth in the Treasury Regulations for some years. The Circuit Court of Appeals conceded (R. 130) that the statutory language showed a clear intent on the part of Congress to make the amendment applicable to the 1938 Act.[12] Although the Committee Reports which accompanied the drafts of the legislation specifically stated that the added statutory language is clarifying in purpose (see Appendix B, *infra*, pp. 33, 34, 35), the Circuit Court of Appeals disregarded the Congressional declaration of purpose upon the theory that the declaration "was eliminated before its passage."

The court has seriously confused the Congressional Committee Reports with the drafts of the Act. None of the drafts of what became Section 501 ever contained any statement that the purpose of the amendment was "to clarify the law;"

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[12] Respondents may assert, as they did below, that the effective date of Section 501 is ambiguous. However, the effective date of paragraph (b) of Section 501 was inserted to make it clear that the amendment to the Internal Revenue Code was effective as of the effective date of the Code, while paragraph (c) extended the effective date to prior Revenue Acts outside the Code itself. (See S. Rep. No. 2114, 76th Cong., 3d sess., Appendix B, *infra*, pp. 36–37.)

that language appeared in the Committee Reports, and it remains in those reports and characterizes the amendment as clarifying. Such a declaration of Congressional purpose should be conclusive. *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 322; cf. *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455, 468–469; *Commissioner* v. *Bristol*, 121 F. 2d 129, 135 (C. C. A. 1st). A judicial rejection of such a declaration jeopardizes most other clarifying amendments to the many other sections of the various revenue laws where, as with Section 501 of the Second Revenue Act of 1940, the declaration of Congressional purpose appears only in the Committee Reports. Moreover, the practical effect of the decision below will be to require disputed questions of interpretation of the revenue laws to be brought to this Court for settlement in each instance without the possibility of going to Congress for a clarifying enactment applicable to prior years. This result would mark a most unfortunate step in the relationship of the three branches of Government with respect to enforcement of the tax laws.

2. The Circuit Court of Appeals has held an Act of Congress (Section 501 of the Second Revenue Act of 1940), enacted in exercise of its legislative powers to levy and collect taxes, to be unconstitutional as respects these several tax-

payers. The principle of the decision is broad enough to cover all taxpayers similarly situated, and also, it would seem, all stockholders of any corporation who received distributions from their corporation before the tax year 1939, whether or not in the month of December 1938, and whether or not the distribution was one in complete or in partial liquidation of the corporation. Such a denial of legislative power justifies an exercise by this Court of its power of judicial supervision and review.

3. Treated *arguendo* as retroactive legislation, Section 501 of the Second Revenue Act of 1940 does not violate the principle of permissible retroactivity[11] in the amendment of revenue laws, and the Circuit Court of Appeals erred in holding otherwise. Its decision that the legislation is so objectionably retroactive that it offends the due process clause of the Fifth Amendment conflicts in principle with the decisions of other Circuit Courts of Appeals upholding legislation which is retroactive and not merely clarifying in nature, and is in essential conflict with decisions of this Court upholding retroactive income tax legislation.

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[11] Actually, Section 501 did not impose a tax upon a transaction, the gains of which were not taxable in 1938, but, still assuming that Section 501 was not clarifying but retroactive, reduced the amount of the postponement benefit for the year 1938 which the taxpayers thought they could obtain under Section 112 (b) (7) (E) of the 1938 Act. (See Sections 111, 112 (a), 115 (c), and 117 (b), Revenue Act of 1938.)

The Second Revenue Act of 1940 was passed on October 8, 1940. The stockholders of the John H. Wheeler Company had dissolved their corporation during December 1938. The Circuit Court of Appeals assumed that *Welch* v. *Henry*, 305 U. S. 134, stood for the arbitrary rule that an income tax provision cannot be applied retroactively to a year prior to that succeeding the year of the last previous general session of Congress. We do not so construe that decision. It does not lay down any general rule as to the permissible retroactivity of income tax statutes. In that case, the Court sustained an act of the Wisconsin Legislature passed March 27, 1935, imposing a tax on corporate dividends of a certain type which residents of Wisconsin had received in 1933. The Wisconsin Act was unquestionably retroactive legislation.[14] The Legislature had passed it at its first general session after 1933, and the Court called attention to such circumstance but quite without statement or intimation that an income tax law, retroactive for a longer period, is *per se* invalid.[15]

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[14] Had the Wisconsin Act been "a remedial measure to ratify a doubtful administrative interpretation of prior legislation" (see *Welch* v. *Henry*, *supra*, p. 158), it seems apparent there would have been no dissent in the *Welch case*.

[15] See also *Cooper* v. *United States*, 280 U. S. 409; *United States* v. *Hudson*, 299 U. S. 498; *cf. Milliken* v. *United States*, 283 U. S. 15; *Illinois Central R. Co.* v. *Minnesota*, 309 U. S. 157, 164–165.

The decision below also conflicts in principle with *D. W. Klein Co.* v. *Commissioner*, 123 F. 2d 871 (C. C. A. 7th), certiorari denied, 315 U. S. 819,[16] and *Wilgard Realty Co.* v. *Commissioner*, 127 F. 2d 514 (C. C. A. 2d), certiorari denied, 317 U. S. 655. Those cases arose under the provisions of the Revenue Act of 1932 as retroactively amended by Section 213 (f) (1) of the Revenue Act of 1939, c. 248, 53 Stat. 862, and, in both cases, the 1939 amendment was held effective to change the law as to transactions occurring in 1932. (See also *Commissioner* v. *Corpus Christi T. Co.*, 126 F. 2d 898 (C. C. A. 5th).)

The *Wilgard Realty Co.* case cannot be distinguished upon the ground that there the retroactive legislation was no more burdensome than the taxpayer should have expected when he accomplished the thing creating the tax liability, for the respondents must be deemed to have liquidated their corporation with knowledge of the regulations (Article 115–3 of Treasury Regulations 94 and 101, Appendix A, *infra*, pp. 31–32). The House Committee Report on Section 501 declares that taxpayers had generally concurred in the rule ap-

[16] The court below sought to distinguish the instant case from the *D. W. Klein Co.* case upon the assumed ground (R. 129) that "at no point in that case was the question of the retroactive nature of the legislation raised." The court was not informed upon the point; the D. W. Klein Company did challenge the retroactive amendment as contravening the due process clause of the Fifth Amendment, and its brief in the Circuit Court of Appeals (pp. 11–12, 51–52) so shows.

plied by the Treasury. See p. 34, *infra*. Furthermore, the effect of Section 501, as applied to respondents, was merely to reduce and not to eliminate a benefit which each of them received by electing to be taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938. They still gained an advantage from their election,[11] and it may not be assumed that they would not have liquidated their corporation in December 1938, or have elected to be taxed under Section 112 (b) (7) (E) if they had anticipated the enactment of Section 501 of the Second Revenue Act of 1940. Consequently, the taxpayers here were not injured in the constitutional sense when the amendment, whether clarifying or retroactive, made it clear that their personal holding company was not entitled to a "stepped-up" basis for determining its earnings and profits from the sale of property for which the corporation had merely issued its stock.

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[11] This is illustrated by the case of John H. Wheeler. Under Section 111 (a) (b) of the Revenue Act of 1938, Appendix A, *infra*, p. 21, he realized a gain of $158,830.91 ($312,335.92 minus $153,505.01) upon the liquidation of his corporation (R. 60, 63). (The actual gain was $159,177.85 as the Tax Court noted (R. 78, cf. R. 24).) If the profits so realized had been taxed otherwise than under Section 112 (b) (7) (E), 50 percent of Wheeler's gain, or $79,588.93, would have been taxed. Section 115 (c) and 117 (b) of the Revenue Act of 1938. The amount which the Commissioner proposed to tax Wheeler under Section 112 (b) (7) (E), was $66,809.55 (R. 25), reduced by the Tax Court to $63,833.02 (R. 78–81).

It should be noted that the statutory provision here condemned is not a one-way enactment. The availability of earnings or profits, or the want thereof, will operate to the advantage or disadvantage of the taxpayer, depending upon the circumstances confronted. A position contrary to that taken by the Treasury with Congressional approval would result in larger taxes in many situations. Thus, for example, earnings and profits available for dividends are minimized for tax purposes, under the Government's position, where there is a corporate gain on reorganization, unrecognized for tax purposes, and the property therein acquired has not been sold. See Paul, *Studies in Federal Taxation, Second Series,* 149, 185–199. This feature of the Treasury's position confirms its fairness and that of Section 501 of the Second Revenue Act of 1940.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that these petitions should be granted.

CHARLES FAHY,
Solicitor General.

AUGUST 1944.

APPENDIX A

Revenue Act of 1938, c. 289, 52 Stat. 447:

TITLE I—INCOME TAX

* * * * *

SUBTITLE C—SUPPLEMENTAL PROVISIONS

* * * * *

Supplement B—Computation of Net Income

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of

the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

(7) *Election as to Recognition of Gain in Certain Corporate Liquidations.*—

(A) *General Rule.*—In the case of property distributed in complete liquidation of a domestic corporation, if—

(i) the liquidation is made in pursuance of a plan of liquidation adopted after the date of the enactment of this Act, whether the taxable year of the corporation began on, before, or after January 1, 1938; and

(ii) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within the month of December, 1938—

then in the case of each qualified electing shareholder (as defined in subparagraph (C)) gain upon the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the

extent provided in subparagraphs (E) and (F).

(B) *Excluded Corporation.*—The term "excluded corporation" means a corporation which at any time between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive, was the owner of stock possessing 50 per centum or more of the total combined voting power of all classes of stock entitled to vote on the adoption of such plan.

(C) *Qualified Electing Shareholders.*—The term "qualified electing shareholder" means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election to have the benefits of subparagraph (A) has been made and filed in accordance with subparagraph (D), but—

(i) in the case of a shareholder other than a corporation, only if written elections have been so filed by shareholders (other than corporations) who at the time of the adoption of the plan of liquidation are owners of stock possessing at least 80 per centum of the total combined voting power (exclusive of voting power possessed by stock owned by corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation; * * *

* * * * *

(D) *Making and Filing of Elections.*—The written elections referred to in subparagraph (c) must be made and filed in such manner as to be not in contravention of regulations prescribed by the Commissioner with the approval of the Secretary.

The filing must be within thirty days after the adoption of the plan of liquidation, and may be by the liquidating corporation or by the shareholder.

(E) *Noncorporate Shareholders.*—In the case of a qualified electing shareholder other than a corporation—

(i) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December, 1938; and

(ii) There shall be recognized, and taxed as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after April 9, 1938, exceeds his ratable share of such earnings and profits.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(8) *Property Acquired by Issuance of Stock or as Paid-in Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including,

also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently

accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two

years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938. In the case of amounts distributed (whether before January 1, 1938, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *

* * * * *

Each of the above sections of the Revenue Act of 1938 was carried into the corresponding section of the Internal Revenue Code passed February 10, 1939, except subparagraph (7) of Section 112 (b), *supra*, pp. 22–24.

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made)

for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. * * *

* * * * * *

(b) *Effective Date of Amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which,

on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

(26 U. S. C., Sec. 115.)

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 112 (b) (7)-1. *Corporate liquidations in December, 1938.*—(*a*) *General.*—Section 112 (b) (7) provides a special rule, in the case of certain specifically described complete liquidations of domestic corporations occurring within the month of December, 1938, for the treatment of gain on the shares of stock owned by qualified electing shareholders on the date of the adoption of the plan of liquidation. The effect of such section is in general to postpone the recognition of that portion of a qualified electing shareholder's gain on the liquidation which would otherwise be recognized and which is attributable to appreciation in the value of certain corporate assets unrealized by the corporation at the time such assets are distributed in complete liquidation. Only qualified electing shareholders are entitled to the benefits of section 112 (b) (7). The determination of who is a qualified electing shareholder is to be made under section 112 (b) (7) (C) and article 112 (b) (7)-2. For the basis of property received on such liquidations, see section 113 (a) (18).

(*b*) *Type of liquidation.*—The liquidation must be in pursuance of a plan of liquidation adopted after May 28, 1938. * * *

If a transaction constitutes a distribution in complete liquidation within the

meaning of the Act and satisfies the requirements of section 112 (b) (7), it is immaterial that it is otherwise described under the local law.

ART. 112 (b) (7)–4. *Treatment of gain.*—(*a*) *Computation of gain.*—As in the case of shareholders generally, for the purpose of computing gain, amounts received by qualified electing shareholders are treated as in full payment in exchange for their stock, as provided in section 115 (*c*), and gain from the receipt of such amounts is determined as provided in section 111. * * *.

(*b*) *Recognition of gain.*—Pursuant to section 112 (b) (7) only so much of the gain on each share of stock owned by a qualified electing shareholder on the date of the adoption of the plan of liquidation is recognized as does not exceed the greater of the following—

(1) Such share's ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, computed as of December 31, 1938, without diminution by reason of distributions made during the month of December, 1938; or

(2) Such share's ratable share of the sum of the amount of money received by such shareholder on shares of the same class and the fair market value of all the stock or securities so received which were acquired by the liquidating corporation after April 9, 1938. * * *

(*c*) *Treatment of recognized gain.*—In the case of a qualified electing shareholder other than a corporation that part of the recognized gain on a share of stock owned on the date of the adoption of the plan of liquidation which is not in excess of its

ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, determined as provided in section 112 (b) (7) (E) (i) is treated and taxed to him as a dividend. It retains its character as a dividend for all tax purposes. The remainder of the gain which is recognized is treated and taxed to him as a short-term or long-term capital gain, as the case may be. * * *

* * * * *

ART. 115-2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. * * *

* * * * *

ART. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses

are recognized under that section.[1] Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

* * * * * *

ART. 115–5. *Distributions in liquidation.*—(*a*) *General.*—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and article 111–1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112.

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[1] This sentence appears in the regulations promulgated under preceding Revenue Acts: Article 115–3, Treasury Regulations 94 (1936 Act); Article 115–1, Treasury Regulations 86 (1934 Act). The same sentence appears in the Treasury Regulations promulgated under the Internal Revenue Code: Sec. 19.115–3, Treasury Regulations 103 and Sec. 29.115–3, Treasury Regulations 111. See, also, Sections 19.115–12 and 29.115–12 of the same Regulations.

APPENDIX B

COMMITTEE REPORTS

THE SECOND REVENUE BILL OF 1940

H. Rep. No. 2894, 76th Cong., 3rd Sess., p. 41 (1940–2 Cum. Bull. 496, 526–527):

SECTION 401. EARNINGS AND PROFITS OF CORPORATIONS.

The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (l) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome* (60 Fed. (2d), 931) and following decisions, the rule effectuates the provisions of section 112.

While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. For example, on January 1, 1930, the X Corporation owned stock in the Y Corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was $100. The fair market value of the stock in the Y Corporation received by the X Corporation was $1,000. On April 9, 1930, the X Corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1929, had no accumuated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y Corporation over the basis, $900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner* v. *F. J. Young Corporation,* 103 Fed. (2d), 137). Under the proposed legislation and Treasury practice, the $900 would not represent earnings or profits, and the cash distribution would not be a taxable dividend. The need for certainty, not only with respect to the determination of when dividends are taxable but also in the computation of the excess profits tax credit, makes it desirable to clarify existing law.

* * * * *

It should be noted that the provisions of section 401 are applicable only in deter-

mining the earnings or profits for periods beginning after February 28, 1913. * * *

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S. Rep. No. 2114, 76th Cong., 3rd Sess., pp. 22, 26 (1940–2 Cum. Bull. 528, 545–548):

SECTION 501. EARNINGS AND PROFITS OF CORPORATIONS.

The committee amendment rearranges section 401 of the House bill but otherwise makes no substantial change. * * *

* * * * *

The subsection also provides that the realized gain or loss shall increase or decrease the earnings and profits (for any period beginning after February 28, 1913) to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. This provision relates to gains or losses which are recognized, pursuant to the provisions of law, for instance, by reason of the provisions of section 112 of the Internal Revenue Code. * * * For example, on January 1, 1939, the X Corporation owned stock in the Y Corporation which it had acquired in 1938 in an exchange transaction in which no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was $100. The fair market value of the stock in the Y Corporation when received by the X Corporation was $1,000. On April 9, 1939, the X Corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1938, had no ac-

cumulated earnings or profits. The excess of the fair market value of the stock of the Y Corporation over the basis, $900, was not recognized gain under the provisions of section 112 of the Revenue Act of 1938. Accordingly, its earnings and profits are not increased by $900 and the distribution was not out of earnings and profits.

The subsection applies regardless of the form taken by the sale or other disposition resulting in the accumulation of earnings and profits. For example, suppose that oil property which X had acquired in 1922 at a cost of $28,000 was transferred to a corporation in 1924 in exchange for all of its capital stock; that the fair market value of the stock and of the property as of the date of the transfer was $247,000; and that the corporation, after three years' operations, effected in 1927 a cash distribution to X in the amount of $165,000. In determining the extent to which the earnings and profits of the corporation available for dividend distributions have been increased as the result of production and sale of oil, it is intended that depletion should be taken into account computed upon the basis of $28,000 established in the nontaxable exchange in 1924 regardless of the fair market value of the property or the stock issued in exchange therefor.

* * * * *

The amendments to the Internal Revenue Code made by section 501 (a) are by section 501 (c) made applicable to all prior Revenue Acts, effective as if they were a part of such Act on the date of its enactment, thus effecting the application

of a uniform rule for the determination of the earnings and profits of all corporations for all prior taxable years. The last sentence of the subsection provides that only the actual tax liability of a shareholder taxpayer for a particular year which is now pending before, or heretofore determined by, the Board of Tax Appeals or any court of the United States, shall remain unaffected by the provisions of section 501. These cases now actually in litigation are left to be determined as the Board or the court may see fit. The result is that the decision in each of these cases will merely determine the tax liability for the particular year of the particular taxpayer, but for every other purpose the determination of the earnings and profits, and of all matters dependent upon such determination the provisions of section 501 govern. Section 501 will therefore control for all purposes as respects the corporation, and as respects the shareholder in litigation for every purpose except that the tax liability for the particular year, as finally determined by the Board or the court, will remain undisturbed.

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